Proposition 65

Local Government Funds and Revenues. State Mandates. Initiative Constitutional Amendment.

BACKGROUND

Local Government Funding

California has over 5,000 local governments—cities, counties, special districts, and redevelopment agencies—that provide services such as fire and police protection, water, libraries, and parks and recreation programs. Local governments pay for these programs and services with money from local taxes, fees, and user charges; state and federal aid; and other sources. Three taxes play a major role in local finance because they raise significant sums of general-purpose revenues that local governments may use to pay for a variety of programs and services. These three taxes—the property tax, the local sales tax, and the vehicle license fee (VLF)—are described in Figure 1.

Figure 1

Three Major Local Government Taxes

Property Tax

- Local governments receive general-purpose revenues from a 1 percent property tax levied on real property.
- During the 2003-04 fiscal year, local governments received approximately $15 billion in property tax revenues. (An additional $16 billion in property taxes went to schools and community colleges.)
- There is wide variation in the share of property taxes received by individual local governments. This variation largely reflects differences among local agency property tax rates during the mid-1970s, the period on which the state's property tax allocation laws are based.

Vehicle License Fee (VLF)

- The VLF is a tax levied annually on the value of vehicles registered in the state.
- For about a half century, the VLF rate was 2 percent of vehicle value. In 1999, the Legislature began reducing the rate charged to vehicle owners, with the state "backfilling" the resulting city and county revenue losses.
- During 2003-04, the VLF (set at a rate of 0.65 percent of vehicle value) and the VLF backfill would have provided about $5.9 billion to cities and counties. The state, however, deferred payment of part of the backfill to 2006.
- State law generally requires that three-quarters of VLF revenues be allocated to cities and counties on a population basis for general-purpose uses and the remaining VLF revenues be allocated to counties for health and social services programs.

Local Sales Tax

- Cities and counties receive revenues from a uniform local sales tax levied on the purchase price of most goods—such as clothing, automobiles, and restaurant meals.
- During 2003-04, this tax was levied at a rate of 1.25 percent and generated about $5.9 billion.
- Under current law, 80 percent of sales tax revenues are distributed to local governments based on where sales occur—to a city if the sale occurs within its boundaries, or to a county if the sale occurs in an unincorporated area. The remaining 20 percent of local sales tax revenues are allocated to counties for transportation purposes.
- Beginning in 2004-05, local governments will receive additional property taxes to replace some local sales tax revenues that are pledged to pay debt service on state deficit-related bonds, approved by voters in March 2004.

State Authority Over Local Finance

The State Constitution and existing statutes give the Legislature authority over the three major taxes described in Figure 1. For example, the Legislature has some authority to change tax rates; items subject to taxation; and the distribution of tax revenues among local governments, schools, and community college districts. The state has used this authority for many purposes, including increasing funding for local services, reducing state costs, reducing taxation, and addressing concerns regarding funding for particular local governments. Figure 2 describes some past actions the Legislature has taken, as well as actions that the state was considering during the summer of 2004 (at the time this analysis was prepared).

Figure 2

Major State Actions Affecting Local Finance

Past Actions

Increasing Funding for Local Services. In 1979, the state shifted an ongoing share of the property tax from schools and community colleges to local governments (cities, counties, and special districts). This shift limited local government program reductions after the revenue losses resulting from the passage of Proposition 13, but increased state costs to backfill schools' and community colleges' property tax losses.

Reducing State Costs. In 1992 and 1993, the state shifted an ongoing share of property taxes from local governments to schools and community colleges. This had the effect of reducing local government resources and reducing state costs. The state also reduced its costs by deferring payments to local governments for state mandate reimbursements (most notably, in 2002 and 2003) and for a portion of the VLF backfill (2003).

Reducing Taxation. Beginning in 1999, the state reduced the VLF rate to provide tax relief. The state "backfilled" the resulting city and county revenue losses

Addressing Concerns Regarding Funding for Specific Local Governments. In the past, the state has at various times adjusted the annual allocation of property taxes and VLF revenues to assist cities that received very low shares of the local property tax.

Proposals Under Consideration in July 2004

Reducing State Costs. The state was considering shifting $1.3 billion of property taxes in 2004-05 and in 2005-06 from local governments to schools and community colleges to reduce state costs. The state also was considering deferring 2004-05 mandate payments to local governments.

Restructuring Local Finance. The state was considering replacing city and county VLF backfill revenues with property taxes shifted from schools and community colleges.

Requirement to Reimburse for State Mandates

The State Constitution generally requires the state to reimburse local governments, schools, and community college districts when the state "mandates" a new local program or higher level of service. For example, the state requires local agencies to post agendas for their hearings. As a mandate, the state must pay local governments, schools, and community college districts for their costs to post these agendas. Because of the state's budget difficulties, the state has not provided mandate reimbursements in recent years. Currently, the state owes these local agencies about $2 billion for prior-years' costs of state-mandated programs.

PROPOSAL

Limitations on Legislature's Authority to Change Local Revenues

This measure amends the State Constitution to significantly reduce the Legislature's authority to make changes affecting any local government's revenues from the property tax, sales tax, and VLF. Specifically, the measure requires approval by the state's voters before a legislative measure could take effect that reduced a local government's revenues below the amount or share it would have received based on laws in effect on January 1, 2003. For example, this measure would require statewide voter approval before a law took effect that:

- Shifted property taxes from local governments to schools and community colleges.
- Changed how sales taxes are distributed among cities and counties.
- Exchanged city sales taxes for increased property taxes.
- Revised the formulas used to distribute property taxes among local governments.

Proposition 65 also would suspend any law enacted after November 1, 2003 that would have required voter approval under the terms of this measure. Suspended laws would take effect only if they were approved by the state's voters at the next statewide election.

The measure provides two exceptions to these voter-approval requirements. The state could enact laws that (1) shift property taxes among consenting local governments or (2) replace VLF revenues with an equal amount of alternative funds.

This measure also places into the State Constitution two existing state statutes relating to local finance. These statutes require the state to pay deferred VLF backfill revenues to cities and counties ($1.2 billion) by August 2006 and reestablish the local sales tax rate at 1.25 percent after the state's deficit-related bonds are paid.

State Mandates

The measure amends the State Constitution to reduce the state's authority over local government, school, and community college programs. Specifically, if the state does not provide timely reimbursement for a mandate's costs (other than mandates related to employee rights), local agencies could choose not to comply with the state requirement. The measure also appears to expand the circumstances under which the state would be responsible for reimbursing local agencies for carrying out a new state requirement. For example, the measure may increase the state's responsibility to reimburse local governments when the state increases a local agency's share of cost for a jointly financed state-local program.

FISCAL EFFECTS

Proposition 65 would reduce state authority over local finances. Over time, it could have significant fiscal impacts on state and local governments, as described below.

Long-Term Effect on Local and State Finance

Higher and More Stable Local Government Revenues. Given the number and magnitude of past state actions affecting local taxes, this measure's restrictions on the state's authority to enact such measures in the future would have potentially major fiscal effects on local governments. For example, a legislative measure that reduces local government revenues may not receive the necessary voter approval required under this measure. In addition, there may be other cases where the Legislature and Governor do not pursue legislation to reduce local revenues because of the perceived difficulty in obtaining voter approval. In these cases, this measure would result in local government revenues being more stable—and higher—than otherwise would be the case. The magnitude of increased local revenues is unknown and would depend on future actions by the Legislature, the Governor, and the state's voters. Given past actions by the state, however, this increase in local government revenues could be in the billions of dollars annually. These increased local revenues could result in higher spending on local programs or decreased local fees or taxes.

Lower Resources for State Programs. In general, the measure's effect on state finances would be the *opposite* of its effect on local finances. That is, this measure could result in decreased resources being available for state programs than otherwise would be the case. This reduction, in turn, would affect state spending and/or taxes. For example, if the state's voters rejected a proposal to use local government property taxes as part of the state's budget solution, the Legislature would need to take *alternative* actions to resolve the state's budget difficulties—such as increasing state taxes or decreasing spending on other state programs. As with the local impact, the total fiscal effect also could be in the billions of dollars annually.

Less Change to the Revenue of Individual Local Governments. Proposition 65 restricts the state's authority to reallocate local tax revenues to address concerns regarding funding for specific local governments or to restructure local government finance. For example, measures that changed how local sales tax revenues are allocated to cities and counties, or that shifted property taxes from a water district to another special district, would not become effective until approved by voters at a statewide election. If the state's voters did not approve such reallocations, or if the Legislature and Governor did not pursue them because of the perceived difficulty in obtaining voter approval, this measure would result in fewer changes to local government revenues than otherwise would have been the case.

Potential Immediate Effect on Local and State Finance

This analysis was prepared in mid-July, before the state's budget for 2004-05 was adopted. At that time, the Legislature was considering the Governor's proposal to shift $1.3 billion of property taxes from local governments to schools and community colleges in 2004-05 and again in 2005-06. This shift would reduce local government resources by $1.3 billion in each of the two years. It would also decrease state costs by comparable amounts (because higher property taxes to schools and community colleges result in lower state education costs). This property tax shift, if adopted in the 2004-05 budget, would be affected by passage of Proposition 65. That is, the property tax shift would be suspended until voted upon at the subsequent statewide election (currently scheduled for March 2006). If voters approved the shift proposal, it would go into effect. If voters rejected the proposal, it would not go into effect, and the fiscal impacts described above would be reversed. That is:

- Local governments would retain the $1.3 billion in property tax revenues in 2004-05 and in 2005-06.
- The state would experience increased costs of comparable amounts.

Effect on Local Programs and State Reimbursements

Because the measure appears to expand the circumstances under which the state is required to reimburse local agencies, the measure may increase future state costs or alter future state actions regarding local or jointly funded state-local programs. While it is not possible to determine the cost to reimburse local agencies for potential future state actions, our review of state measures enacted in the past suggests that, over time, increased state reimbursement costs could exceed a hundred million dollars annually.